Economic Outlook and Monetary Policy

32nd Annual Economic Seminar
Sponsored by the Simon Graduate School of Business, Rochester Business Alliance, and JPMorgan Chase & Co.

Rochester, NY

December 2, 2010

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President and CEO
Federal Reserve Bank of Philadelphia

FEDERAL RESERVE BANK
OF PHILADELPHIA

The views expressed today are my own and not necessarily those of the Federal Reserve System or the FOMC.

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Introduction

Thank you for that warm welcome. I am delighted to be back in Rochester. It is always wonderful to see old friends and familiar faces. Having participated in this event for 32 years, and having lived here for nearly as long, Rochester will always feel like home to me. I have enjoyed the richness of the discussions we have had over the years, through both good and bad forecasts, and I am honored that the Simon School, the Rochester Business Alliance, and JPMorgan Chase continue to welcome me back.

Over the last few years, both here and elsewhere, I have noted that these are interesting and challenging times for the economy and for policymakers. I suspect that we all would welcome a little more boredom and a little less challenge. Nevertheless, challenges remain and today I will discuss current monetary policy, including the Fed's decision to begin a new round of large-scale asset purchases. Because appropriate monetary policy is forward looking and conditional on the outlook for the economy, I will start by highlighting my views on our nation's economic recovery and my outlook for growth and inflation. Before continuing, I should note that my views are my own and not necessarily those of the Federal Reserve Board or my colleagues on the Federal Open Market Committee.

The Economic Outlook

When we met a year ago, I told you that I believed the economy was in a recovery and that I had become more confident that it would be a sustainable one. We now know, thanks to the Business Cycle Dating Committee of the National Bureau of Economic Research, that the recession ended in June 2009. However, the pace of the recovery since then has been uneven and slower than anyone would like. Yet, this slow pace was not unexpected, given the severity of the recession and the financial nature of the shocks that precipitated it. Remember the economy lost more than 8 million jobs – a 6 percent decline in employment – and households lost more than $12 trillion in net worth. So, some necessary rebalancing is taking place.

Consumers and businesses are in the process of deleveraging and rebuilding their savings. Activity in the housing industry will continue to languish until housing inventories are reduced. State and local governments are cutting spending to make up for lower tax revenues. And the unemployment rate remains high at 9.6 percent, as displaced workers vie for available open positions. Uncertainties surrounding fiscal policies and the costs they will impose on businesses have also weighed down the recovery.

So, while we are in our sixth quarter of economic recovery, it doesn't feel like one for many people. Admittedly, growth for 2010 will be somewhat lower than the 3 percent annual rate that I projected a year ago. We started out the year with a fairly nice rebound. Real GDP grew at a 3¾ percent pace in the first quarter as firms began to restock the inventories they had drastically cut during the recession. House sales were boosted temporarily by the homebuyers' tax credits, which pulled sales forward. However, when the credits ended, sales dropped off sharply. So going into late spring and early summer, the pace of the recovery slowed to less than 2 percent, due in part to the expected decline in housing sales. The mood and tone of the recovery were further shaken by the sovereign debt problems in Europe, which led some to worry that the economy could dip back into recession. While this loss of momentum did cause me to revise down my forecast for the year, I was less concerned about a double dip. History has taught us that recoveries are rarely a smooth upward trajectory. Yet, the most recent data suggest that the economy is emerging from the summer doldrums. Growth in the third quarter accelerated to 2½ percent and readings on consumer spending and manufacturing activity have also picked up.

As we end 2010, I now project that GDP growth will be around 2½ percent for this year and will pick up to 3 to 3½ percent annually over the next two years. A key to this growth will be increased private demand, which is essential for a sustainable recovery. While neither business spending nor consumer spending is likely to take off rapidly, I do expect continued improvement in economic conditions that will support moderate growth going forward. As with all forecasts, this projection carries some risks. But for now, I expect moderate growth overall, with strength in some sectors offsetting weakness in others.

Housing is one sector that I expect to remain weak. We entered the recession highly overinvested in residential real estate, and the sector is likely to remain depressed for a while longer. Commercial real estate markets are also weak. Nonresidential construction spending declined this year, and I do not see much growth until after the economy is well into a healthy expansion.

In contrast, business spending on plant and equipment is strengthening. While some smaller firms report difficulties in getting access to credit, banks have begun to ease credit terms and loan rates are at historic lows. Larger firms have been able to finance investment out of retained earnings or to issue new debt on very favorable terms. Some of these investments have been used to replace aging equipment; some have gone toward productivity improvements, which are good for the economy in the long run.

The Philadelphia Fed's monthly Business Outlook Survey of regional manufacturers showed significant improvement in general activity, orders, and shipments in

November, following some weakness during the summer months. The survey's measures of expected future activity indicate that businesses are becoming more optimistic as well. So I expect business to continue to make these fixed investments at a healthy pace over the coming year.

Consumer spending, though, makes up about 70 percent of economic activity in the U.S., so the speed of the overall recovery will depend on how the household sector fares. Even during recessions, it is rare to see sustained declines in consumer spending. Yet in 2008, households cut their spending by over 1¾ percent (measured fourth quarter over fourth quarter). This was the first yearly decline since 1980, and the largest since World War II. The fall in house prices and the decline in equity portfolios hit households hard, destroying the net worth that had supported spending. Additionally, job losses have meant lower incomes. Concerns about future job losses caused consumers to retrench. However, households are now in the process of shoring up their balance sheets. As debt levels fall, and savings are rebuilt, consumers will be in a better position to spend. But with unemployment remaining stubbornly elevated, aggregate wealth will recover only slowly. Those who have lost their homes or spent down their savings while unemployed will recoup their losses only over time. This year, consumer spending is up at a 3 percent pace. I don't expect a stronger rebound without more improvement in the labor markets.

So far, the private sector has added over a million jobs this year, reflecting some of the reallocation of displaced workers into new positions. Unfortunately, the pace of employment growth hasn't been strong enough to make much of a dent in the unemployment rate. When we met last year, the unemployment rate was 10 percent. Over the course of a year, it has fallen less than half a percent to 9.6 percent, as noted earlier. Like most forecasters, I believe that the moderate pace of the recovery in output growth suggests that we will continue to see improvement in labor markets, but that improvement will be a gradual one. I expect the unemployment rate will fall to around 8 to 8½ percent by the end of next year. I wish I could forecast a faster improvement, but it will take time to resolve the difficult adjustments now under way in the labor markets. The contraction in the real estate sector and in sectors closely related to residential construction, such as mortgage brokerage, means that many workers will likely need to find jobs in other industries and this will take time. The productivity gains occurring in other sectors also suggest that many workers may need updated skills to find their next job. This may be particularly relevant for the long-term unemployed. Monetary policy will not help these types of adjustments in the labor markets go any faster.

Inflation

Unlike employment, inflation is ultimately a monetary phenomenon. Headline CPI inflation has been near 1 percent this year. Even if we omit the prices of energy and food, which tend to be volatile, core CPI inflation has been just under 1 percent this year, down from 1¾ percent last year. These low inflation rates have led some observers to voice concerns that we may be entering a period of prolonged decline in the level of prices, or sustained deflation.

While I do expect that inflation will be subdued in the near term, I do not see a significant risk of a sustained deflation. Nominal GDP has been growing at an annual rate of more than 4 percent this year. In contrast, during Japan's lost decade of the 1990s, when deflation was a serious problem, nominal growth was essentially zero. Responders to the Philadelphia Fed's fourth-quarter Survey of Professional Forecasters see only a slight chance of deflation next year. While inflation is currently lower than the 1½ to 2 percent level many monetary policymakers would like to see, it does not follow that sustained deflation is imminent or even likely. It is useful to remember that the U.S. saw average consumer price inflation of just 1.3 percent through most of the 1950s and early 1960s. This period of low inflation did not lead to fears of deflation nor did it lead to economic stagnation.

Moreover, brief periods of lower-than-desired inflation or even temporary deflation are unlikely to materially affect economic outcomes, unless they destabilize inflation expectations in a period when monetary policy could not respond, because rates were already near zero. In that case, real interest rates would rise, which would encourage consumers and businesses to save more and spend less. Given that the Fed's policy rate is now close to zero, a decline in inflation expectations would undermine the recovery. Fortunately, this is not happening. Expectations of medium- to long-term inflation have remained relatively stable because people expect the Fed to take appropriate action to keep inflation low, positive, and stable. As the recovery continues, I anticipate that inflation will return toward 2 percent over the course of the next year.

Monetary Policy

With inflation currently running lower than what many policymakers would prefer, and with unemployment remaining very high, the FOMC voted in November to once again begin purchasing assets to expand its balance sheet. The FOMC stated its intention to purchase an additional $600 billion of longer-term Treasury securities by the end of the second quarter of 2011.

The public has dubbed this recent asset purchase program "QE2," which does not refer to the famous ocean liner but to the Fed's second round of asset purchases – what some call quantitative easing. Nearly two years ago, after the Fed had reduced the federal funds rate to near zero, it began a program to purchase up to $1.75 trillion in agency mortgage-backed securities, agency debt, and long-term Treasuries. This purchase program was completed in March 2010. If the Fed completes the full amount of the second round, the Fed's balance sheet will have more than tripled since mid-2007. The amount of excess reserves held by banks will approach $1.5 trillion.

Chairman Bernanke has stated that the intention of the current program is "to support the economic recovery, promote a faster pace of job creation, and reduce the risk of a further decline in inflation."[1] Proponents expect the security purchases to lower longer-term interest rates through a portfolio balance effect. That is, as the supply of longer-term Treasuries available to the public is reduced, prices of Treasuries should rise, which means yields should fall, to induce the public to willingly hold the reduced supply. Yields on similar assets are expected to fall as the public rebalances portfolios away from the asset with reduced supply toward other similar assets. Just as in conventional monetary policy, lower interest rates would stimulate business and consumer demand and increase exports, thus lending support to the recovery. In some models, the increase in demand leads to a rise in price levels.

I would note that the U.S. Treasury could achieve this same portfolio balance effect, in principle, without the Fed's involvement, if it chose to issue fewer long-term bonds and more short-term securities. The Treasury would, of course, face interest rate risk if, when the time came to roll over this short-term debt, interest rates were higher, costing the taxpayer more to fund the debt. Yet, the Federal Reserve also faces interest rate risk by purchasing these long-term government bonds. If rates go up and the Fed were forced to sell the bonds in order to prevent inflation, the Fed would take a loss – but so would the Treasury, since the Fed would not be able to remit as much income back to the Treasury as it otherwise could. Thus, the public bears the same risk exposure whether the policy is conducted by the Fed or the U.S. Treasury.

Because the policy had been anticipated well before the Fed took action in November, there had already been considerable public discussion of the pros and cons of the second round of asset purchases. At that time, based on my reading of the economic outlook, I expressed the view that I did not think the benefits outweighed the costs.

I am still somewhat skeptical that we will see much of a stimulative effect from the new round of purchases. The Fed's first purchase program worked to lower interest rates,

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[1] Ben Bernanke, "Rebalancing the Global Recovery," speech at the Sixth European Central Bank Central Banking Conference, Frankfurt, Germany, November 19, 2010.

although estimates vary quite a lot. Some studies suggest that the effect was 30 to 60 basis points. Others found a much smaller impact.[2] Yet, these purchases were done at a time when financial markets were highly disrupted and asset risk premiums were extremely elevated. But markets are no longer disrupted, so we cannot expect the same effect this time. Even if we did, it is not clear to me that a further reduction in long-term interest rates will do much to speed up the reduction in the unemployment rate to more acceptable levels. Indeed, if asset purchases don't do much to accelerate aggregate demand, then the argument that the program will reduce the risks of deflation is also substantially weakened. The asset purchase program may help anchor expectations of inflation and ensure that they don't fall. However, one might ask why adding $600 billion of additional excess reserves would help anchor expectations of inflation any more so than the $1 trillion currently in the system.

Thus, I think that the benefits of the purchase program may be modest. On the other hand, one cost of expanding the Fed's balance sheet is that it will complicate our exit strategy from a very accommodative monetary policy, when that time comes.

History tells us that exiting from an accommodative monetary policy is always a bit tricky. It is easier to cut rates than it is to raise them. As I discussed last year, monetary policy must be forward looking because it works on the economy with a lag. This means that the Fed will need to begin removing policy accommodation before the unemployment rate has returned to an acceptable level in order to avoid overshooting, which would result in greater instability in the economy.

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[2]See, for example, Joseph Gagnon, Matthew Raskin, Julie Remache, and Brian Sack, "Large-Scale Asset Purchases by the Federal Reserve: Did They Work?" New York Fed Staff Report No. 441, March 2010, and James D. Hamilton and Jing (Cynthia) Wu, "The Effectiveness of Alternative Monetary Policy Tools in a Zero Lower Bound Environment," manuscript, Department of Economics, University of California-San Diego, August 25, 2010, revised November 3, 2010.

While the high level of excess reserves is not inflationary now, as the economic recovery strengthens, the Fed must be able to remove or isolate these reserves to keep them from becoming what I have called the kindling that could fuel excessive inflation. In other words, if banks began to put the reserves to use in the same manner as they did before the crisis, money in circulation would increase sharply. We do not know when that will happen or how long it will take for the banking system to make the adjustment. To address this looming challenge, the Fed is developing and testing tools to help us prevent such a rapid explosion in money. But, of course, we won't know for certain how effective these new tools are until we need to use them in our exit strategy. Nor do we know how rapidly or how high we may need to raise rates.

Because the Fed's monetary policy must be forward looking, the hue and cry from many quarters may be quite loud when it is time to act. Even with the best of intentions, if we don't act aggressively and promptly, we may find ourselves behind the curve and at risk for substantial inflation. I think we need to bear in mind this future potential complication when considering further expansion of the Fed's balance sheet.

The November FOMC statement indicated that we will regularly review the purchase program in light of incoming economic information and adjusting it as needed to foster our long-run goals of price stability and maximum sustainable employment. I take this intention to regularly review the program seriously, and I will be looking for evidence of the hoped-for benefits as I evaluate the program before each meeting. If we do not see these benefits, I would not infer that we merely need to increase the size of the program. Rather, I would take this as evidence that we need to rethink the analysis of costs and benefits that led us to this policy in the first place. If the economy grows more quickly than I currently anticipate, the purchase program will need to be reconsidered and perhaps curtailed before the full $600 billion in purchases is completed. On the other hand, if serious risks of deflation or deflationary expectations emerge, then we would need to consider whether expanded asset purchases should be used to address these risks. However, we would then need to clearly communicate that we were taking this step to combat deflation and deflationary expectations, and not as an action to speed up the recovery.

Conclusion

In conclusion, our nation's economy is now emerging from the worst financial and economic crisis since the Great Depression. A relatively slow but sustainable economic recovery is under way. I expect growth to be around 2½ percent this year, heading up to 3 to 3½ percent annually over the next two years.

As the economy continues to gain strength and optimism continues to grow among businesses, hiring will strengthen. As it does, the unemployment rate will decline, but it will be a gradual decline. The shocks we experienced were huge, and it will take some time for the imbalances in labor markets to be resolved.

The Federal Reserve remains committed to promoting price stability. This is the most effective way in which monetary policy can contribute to economic conditions that foster maximum sustainable employment.

As we move forward, I will continue to monitor incoming economic developments, update my economic outlook as necessary, and assess whether the stance of monetary policy is well positioned to deliver on our goals. Should evidence suggest that the new round of asset purchases is not delivering its intended benefits, and that policy must be adjusted to foster our long-run goals, I will support an appropriate adjustment in our policy stance.